



A REPORT
TO THE
MONTANA
LEGISLATURE

LEGISLATIVE AUDIT
DIVISION

09P-02

PERFORMANCE AUDIT

Fantasy Sports Parimutuel Gambling

*Board of Horse Racing
Montana State Lottery*

SEPTEMBER 2009

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We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Members of the performance audit staff hold degrees in disciplines appropriate to the audit process. Areas of expertise include business and public administration, journalism, accounting, economics, sociology, finance, political science, english, anthropology, computer science, education, international relations/security, and chemistry.

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September 2009

The Legislative Audit Committee
of the Montana State Legislature:

This report provides the legislature information about the development and administration of a new fantasy sports parimutuel gambling program by the Board of Horse Racing and the Montana State Lottery. This report includes findings and recommendations relating to the legal authority of the Montana State Lottery relative to fantasy sports gambling, and opportunities for improving the process used by the Board of Horse Racing for selecting providers of fantasy sports gambling games.

We wish to express our appreciation to Board of Horse Racing and Montana State Lottery personnel, and staff in other executive branch agencies and offices for their cooperation and assistance during the audit.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Tori Hunthausen".

Tori Hunthausen, CPA
Legislative Auditor

TABLE OF CONTENTS

Figures and Tables.....	ii
Appointed and Administrative Officials	iii
Report Summary	S-1
CHAPTER I – INTRODUCTION.....	1
Introduction.....	1
The Parimutuel System of Gambling and Fantasy Sports.....	1
The Montana State Lottery.....	1
Background.....	1
Implementation of HB616 and the Role of the Montana State Lottery	2
Financial Data for Fantasy Sports Parimutuel Gambling	2
Audit Scope.....	3
Implications of Recent Federal Court Decisions	3
Audit Objectives.....	3
Audit Methodologies.....	4
Report Organization	4
CHAPTER I – IMPLEMENTATION OF FANTASY SPORTS PARIMUTUEL GAMBLING.....	5
Introduction.....	5
Board Rule-Making Procedures.....	5
Basis for Administrative Rules Is Unclear	6
Implementation of Board Rules for Fantasy Sports Parimutuel Gambling.....	6
Agreement With Lottery Circumvents Rule-Based Procedures	7
Problems Exist With Board Licensing Functions for Fantasy Sports	8
Application of the Montana Procurement Act to Fantasy Sports Parimutuel Gambling ..	8
Lack of Open Procurement Process Benefitted Lottery and Contractor.....	9
Licensing Function Is Inappropriate for Fantasy Sports Parimutuel Gambling	10
Statute Should Be Revised to Provide for Contracted Services.....	11
CHAPTER III – LEGAL AUTHORITY FOR LOTTERY’S INVOLVEMENT IN FANTASY SPORTS	13
Introduction.....	13
Legal Challenges to Lottery Involvement.....	13
Interpretation of Statutes Relating to Fantasy Sports Parimutuel Gambling	13
Involving the Lottery Was Expedient, But does not Comply with Statute.....	14
AGENCY RESPONSES.....	A-1
Board of Horse Racing and Montana State Lottery	A-3

FIGURES AND TABLES

Tables

Table 1 Fantasy Sports Retailers’ Lottery Products Sales Revenue..... 10

APPOINTED AND ADMINISTRATIVE OFFICIALS

Board of Horse Racing

Ryan Sherman, Executive Secretary

Sherry Meador, Contracted Legal Counsel

Al Carruthers, Chairman

Ray Tracy, Vice Chairman

Susan Austin, Board Member

John Ostlund, Board Member

Susan Egbert, Board Member

Mike Tatsey, Board Member

Carol Lambert, Board Member

Montana State Lottery

George Parisot, Director

John Tarr, Security Director

Jeri Duran, Sales and Marketing Director

Paul Gilbert, Information Technology Director

Elaine Taylor, Financial Services Director

Montana Lottery Commission

Robert Crippen, Chairman

Craig Anderson, Commission Member

Thomas M. Keegan, Commission Member

Beth O'Halloran, Commission Member

Wilbur Rehmann, Commission Member

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REPORT SUMMARY

Fantasy Sports Parimutuel Gambling

The involvement of the Montana State Lottery in the Board of Horse Racing's fantasy sports parimutuel gambling program does not comply with statute; further legislative action is necessary to ensure this new form of gambling is administered in an equitable and transparent manner.

Audit Findings

In response to a request from the Economic Affairs Interim Committee, the Legislative Auditor prioritized a performance audit of the Board of Horse Racing (the board) and its implementation of fantasy sports parimutuel gambling. House Bill (HB) 616, passed during the 2007 legislative session, provided for fantasy sports gambling to be administered by the board. HB616 authorized extension of the board's authority over parimutuel gambling to fantasy sports leagues. In June 2008 the board entered into an inter-agency agreement with the Montana State Lottery (the Lottery) to provide fantasy sports parimutuel gambling. The Lottery introduced two weekly fantasy sports games based on professional football and auto racing. The games are offered by the Lottery through approximately 200 retail locations.

Fantasy Sports Gambling Statutory Revenue Distribution

Player's Prize Pool	\$134,206
Board of Horse Racing	\$29,018
Montana State Lottery	\$10,882
Retailers	\$7,254
Total	\$181,360

Source: Compiled by the Legislative Audit Division from Montana State Lottery records.

Our audit objectives addressed the board's implementation of fantasy sports gambling via administrative rule. We also addressed concerns over the legality of involving the Lottery. We found the board lacks full legal authority for adopting fantasy sports gambling rules under the Montana Administrative Procedure Act. The rules that were adopted did provide a good basis for implementing the new program, but the board's inter-agency agreement with the Lottery essentially negated these efforts. The board behaved like it was procuring services under

contract, as opposed to granting licensure, but none of the procedures associated with the Montana Procurement Act were applied. The board's actions were a hybrid of licensing and contracting procedures, but ultimately satisfied the requirements of neither. Had the board followed the Procurement Act, several problems could have been avoided. These problems relate to the ability of other market entrants to participate on an equitable basis, and the benefits that ultimately accrued to the Lottery and its main game contractor.

Challenges to the legality of involving the Lottery in fantasy sports gambling focused on the agency's legal authority to offer gambling games that are different from conventional lottery-type products. The Montana State Lottery Act established the Lottery and outlined its legal authority. HB616 did not refer to the Lottery or make any changes in the Lottery Act. Although HB616 did not identify a specific means of implementing fantasy sports gambling, the involvement of the Lottery does not comply with statute. The board, the Lottery and the Governor's Office have stated that involving the Lottery offered an expedient and effective means of implementing the legislation. Although the board and the Lottery obtained legal analysis, they did not seek a resolution of the issues through the Attorney General's office or through legislation during the 2009 legislative session. Either course would have offered an opportunity to clarify legal interpretations regarding the Lottery's scope of authority.

Audit Recommendations

In relation to the board's process for licensing fantasy sports gambling providers, we recommend legislation be enacted to provide the board authority to contract for services, rather than license provision of fantasy sports gambling. Revising statute to provide the board with authority to contract for services would ensure greater transparency in the process and greater confidence in the results. In relation to the Lottery's legal authority to offer fantasy sports gambling, activities that are outside of an agency's legal authority and are not in compliance with statute should cease. We recommend the Board of Horse Racing and the Montana State Lottery terminate their inter-agency agreement on fantasy sports parimutuel gambling with immediate effect.

Chapter I – Introduction

Introduction

In response to a request from the Economic Affairs Interim Committee of the legislature, the Legislative Auditor prioritized a performance audit of the Board of Horse Racing (the board) and its implementation of fantasy sports parimutuel gambling. The board was established in 1965 to regulate the state's horse racing industry. The board's seven members are appointed by the Governor and only two can be representatives of, or involved in, the horse racing industry. The board is administratively attached to the Department of Livestock and currently employs one full-time Executive Secretary.

The Parimutuel System of Gambling and Fantasy Sports

Although most legalized gambling in Montana is regulated by the Department of Justice, horse racing and the associated system of parimutuel gambling are under the authority of the board. Parimutuel gambling differs from fixed odds betting in that winnings are calculated from the cumulative amount wagered by a pool of players. In Montana, the parimutuel system is regulated by the board and the board realizes revenues through licensing of parimutuel gambling providers and from a portion of the takeout (that portion of the total amount wagered not distributed to winners).

House Bill (HB) 616 passed during the 2007 Legislative Session, provided for the introduction of fantasy sports gambling to be administered by the board. HB616 authorized the extension of the board's existing authority over parimutuel gambling to fantasy sports leagues, thereby creating a form of legalized gambling in which players can wager on professional sports by picking a 'fantasy' team of players.

The Montana State Lottery

The Montana State Lottery (the Lottery) was established in 1985 to administer statewide lottery games. The activities of the Lottery are governed by a five-member commission appointed by the Governor and the agency is administratively attached to the Department of Administration. In 2008, the board moved to implement HB616 through an agreement with the Lottery. Under this agreement the Lottery would provide parimutuel gambling games via its existing network that would allow players to bet on fantasy teams in professional sporting events.

Background

HB616 was conceived to provide a source of revenue for the board, which would in turn provide material support for the horse racing industry in Montana. The background to these and other efforts to support the board has been the long-term decline in the

popularity of live horse racing in the state. As race attendance has declined and race meets have been discontinued, the board's revenues from licensing and parimutuel gambling on horse racing have also declined. The board also cites other challenges to the industry, including introduction of new forms of gambling, changing levels of support from county governments, and management issues.

In 2006, Executive Order 33-2006 established the Montana Horse Racing Task Force, which was formed to review options for helping develop the state's horse racing industry. The work of the task force was partly responsible for introduction of HB616 and other legislation addressing horse racing.

Implementation of HB616 and the Role of the Montana State Lottery

Following passage of HB616, the board worked on the development of administrative rules to implement fantasy sports gambling. During the course of 2007 and the first half of 2008 the board was also facing an increasingly difficult budgetary situation, as declining revenues impacted its ability to meet basic expenditure needs. Significant changes occurred in March 2008, as the board's declining budget resulted in the resignation or termination of two staff members. During this time period there was also a change of leadership at the board and a change in direction for the new fantasy sports parimutuel gambling program.

By May 2008, the board had contracted with new staff and was in the early stages of negotiations with the Lottery to provide the new fantasy sports games. The board resumed the process of developing administrative rules for the new program and in June 2008 entered into an inter-agency agreement with the Lottery to provide fantasy sports parimutuel gambling. The Lottery introduced two weekly fantasy sports games based on the National Football League (NFL) and the National Association for Stock Car Auto Racing (NASCAR) race circuit. These games run for most of the year and are offered by the Lottery through around 200 retail locations (retailers must have a full liquor and gambling license to offer the games). The fantasy sports games are marketed by the Lottery as Montana Sports Action and are operated by the Lottery's main game contractor. The games are run via electronic game terminals in retail locations and are networked to a central hub maintained by the contractor, which acts as the parimutuel totalizator or tote (the centralized system for recording bets and calculating winnings).

Financial Data for Fantasy Sports Parimutuel Gambling

Under §23-4-302 (5), MCA, 74 percent of the total amount wagered in fantasy sports parimutuel gambling games is distributed to the players' prize pool. The remaining

26 percent is divided between the board (16 percent), the parimutuel network provider (the Lottery, which receives 6 percent), and the game retailers (4 percent). The two fantasy sports games being offered by the Lottery have generated approximately \$181,000 in total wagers since September 2008. Of this total, the board has received approximately \$29,000 to support the state's horse racing industry.

Audit Scope

Following audit assessment work, we decided to proceed with a performance audit addressing the board's implementation of the new fantasy sports gambling program. Audit scope was focused narrowly to address the implementation of HB616 by the board and the subsequent introduction of fantasy sports parimutuel gambling games by the Lottery. Audit scope therefore excluded the board's licensing activities relating to live race meets, its regulation of the existing live and simulcast parimutuel gambling system, and other activities not related to fantasy sports. Similarly, audit scope addressed the operations of the Lottery only as they relate to the introduction of the Montana Sports Action games. The Lottery's activities relating to administration and marketing of conventional lottery games were not included within the scope of this audit.

Implications of Recent Federal Court Decisions

During the course of audit work, we became aware of several federal judicial decisions relating to the Professional and Amateur Sports Protection Act. This act limits the ability of states to offer certain types of sports betting and is designed to protect the reputation and integrity of professional and amateur sports leagues. In Montana and three other states, sports betting activities that were allowed prior to passage of the act in October 1991 are exempted from the general prohibitions. The board's new fantasy sports parimutuel gambling program was intended to fall within this exemption, making it legal under the federal law. However, a recent decision by a federal appeals court has introduced further uncertainty regarding application of federal law. Because this issue is essentially unresolved at the present time, we excluded federal compliance issues from audit scope, but report it here as an issue for disclosure.

Audit Objectives

Based on our audit scope we developed three audit objectives, which are discussed as follows:

1. Did the Board of Horse Racing develop administrative rules for the fantasy sports parimutuel gambling program in accordance with legal authority, the Montana Administrative Procedure Act, and other applicable laws?
2. Have the Board of Horse Racing and the Montana State Lottery implemented a fantasy sports parimutuel gambling program in accordance with administrative rules and other applicable laws?

3. Did the Board of Horse Racing and other interested parties proceed in accordance with statutory authority and legislative intent in considering options for implementing HB616?

Audit Methodologies

Audit methodologies involved compiling and reviewing information on fantasy sports parimutuel gambling through the following means:

- ♦ Review of information on the Governor's Horse Racing Task Force.
- ♦ Review of legislative records relating to passage of HB616 and interim committee actions relative to the bill.
- ♦ Review of board meeting minutes and other records of public deliberations.
- ♦ Interviews with staff and appointed officials from the board and the Lottery.
- ♦ Interviews with staff and appointed officials from agencies within the Executive branch, including the Governor's Office, the Department of Livestock, the Department of Administration, and the Department of Justice.
- ♦ Interviews with individuals involved in efforts to implement HB616.
- ♦ Legal review and analysis of applicable statutes and rules.
- ♦ Review of financial and other records for the administration and operation of the fantasy sports parimutuel gambling games by the Lottery.
- ♦ Review of federal laws and regulation of gambling in other states.

Report Organization

The remainder of this report includes two chapters addressing our three objectives, discussed as follows:

- ♦ Chapter II addresses the board's licensing functions relative to fantasy sports parimutuel gambling (discussed under our first and second audit objectives).
- ♦ Chapter III addresses the legal authority of the Lottery and whether it can be involved in fantasy sports parimutuel gambling (discussed under our third audit objective).

Chapter I – Implementation of Fantasy Sports Parimutuel Gambling

Introduction

This chapter discusses the process used to develop administrative rules to implement the new fantasy sports parimutuel gambling program. Our first audit objective addressed the development of administrative rules to implement the program by the Board of Horse Racing (the board). Our second audit objective addressed the implementation of these rules by the board in its agreement with the Montana State Lottery (the Lottery). The sections below outline findings and recommendations relating to the following areas:

- ♦ The board's development of administrative rules and compliance with the Montana Administrative Procedure Act.
- ♦ Consistency between the rule-based licensing procedures developed by the board and the inter-agency agreement negotiated with the Lottery.
- ♦ Analysis of the board's overall approach to licensing functions.

Board Rule-Making Procedures

The board began developing administrative rules soon after passage of House Bill (HB) 616 in the summer of 2007. This initial rule-making process lasted for approximately eight months until changes in the membership and staff of the board resulted in changes in direction. Discussions with the present board staff and other individuals involved in the process suggest that rule-making initially focused too narrowly and was taking too much time to complete. Additionally, the board was concerned about complying with federal laws relating to sports gambling and ensuring the rules followed established exemptions in the Professional and Amateur Sports Protection Act. Revised efforts were focused on developing rules in time for the 2008 football season and simplifying the structure of the rules to allow for flexibility in implementing HB616.

Rules addressing fantasy sports parimutuel gambling were adopted as a separate subchapter titled "Parimutuel Wagering on Fantasy Sports Leagues." Individual sections of the subchapter included the following elements addressing the different licensing functions envisioned under the board's rules:

- ♦ Licensing fees for different license types
- ♦ Parimutuel network licenses – duties and requirements
- ♦ Parimutuel network director licenses – duties and requirements
- ♦ Fantasy sports parimutuel hub license – duties and requirements
- ♦ Parimutuel facility license – duties and requirements
- ♦ Fantasy sports coordinator position

The rules also contained sections addressing general issues such as definitions, operational aspects, improper operations and unlawful activity, reporting requirements and enforcement.

Basis for Administrative Rules Is Unclear

Statute grants the board broad authority regarding administrative rules and does not provide any specific guidance on the type or form of licensing the board should pursue for fantasy sports parimutuel gambling. During review of the board's rules, it was noted that statute lacks a specific grant of rule-making authority for fantasy sports parimutuel gambling under §23-4-104, MCA. However, under §23-4-201, MCA, statute refers to the department's authority to issue licenses for participants in fantasy sports parimutuel gambling (it is not clear how this relates to the board's authority). We also reviewed the procedural aspects of the rule-making process to determine whether the board complied with the relevant sections of the Montana Administrative Procedure Act (MAPA). We found that the board acted properly with regards to MAPA requirements for noticing the proposal and adoption of rules, and other procedural aspects.

Given these circumstances, it is unclear whether the board properly complied with all the necessary elements of MAPA. Although the procedural requirements of rule-making appear to have been followed throughout the process, there is some doubt regarding the board's underlying authority for adopting rules for fantasy sports parimutuel gambling. Notwithstanding these concerns, the substance of the rules appears to support the conclusion that the board made a good faith effort to develop an organized regulatory approach for fantasy sports parimutuel gambling. Importantly, the adopted rules did not specifically favor any particular potential applicant (such as the Lottery) and no changes appear to have been made that would have favored or discriminated against certain applicants.

CONCLUSION

Under the Montana Administrative Procedure Act the legal basis for Board of Horse Racing rules on fantasy sports parimutuel gambling is unclear, but the substance of the rules provided a reasonable basis for administering the program.

Implementation of Board Rules for Fantasy Sports Parimutuel Gambling

Prior to the finalization of the administrative rules, the board was in negotiation with the Lottery to act as the parimutuel network provider. The Lottery's involvement

began in May 2008, with negotiations leading to the development of an inter-agency agreement in June 2008. The board and the Lottery actually signed their inter-agency agreement prior to the finalization of the administrative rules for the fantasy sports parimutuel gambling program. In retrospect, this was a troubling indication of the extent to which the board was prepared to implement the rules as they were written.

The mechanism of using the inter-agency agreement to involve the Lottery was modeled on some other similar types of agreements between different agencies of state government. However, while the format of the agreement may have been familiar or accepted, the content does not appear to reflect many of the specific licensure provisions outlined in rule. Despite the board's efforts to develop a licensing structure for fantasy sports gambling through administrative rules, most of these actions were essentially negated by the terms and conditions of the inter-agency agreement

Agreement With Lottery Circumvents Rule-Based Procedures

Several specific provisions in the inter-agency agreement appear to deliberately circumvent or disregard rule-based procedures established by the board:

- ♦ The agreement covers an eight-year term, but the licensing provisions in rule generally specify annual licensure renewable by the board (ARM 32.28.2203(9)).
- ♦ The agreement grants the Lottery exclusivity as the network licensee, but the rules allow multiple licenses (ARM 32.28.2203(1)).
- ♦ The Lottery's central gaming system as maintained by its primary game contractor is designated as the parimutuel hub, but the licensing rules clearly anticipate a separate application process for the hub through the board (ARM 32.28.2205).
- ♦ The agreement waives all network and director fees in contravention of the fee schedule established in rule (ARM 32.28.2202)
- ♦ The agreement delegates licensure of parimutuel facilities to the Lottery, whereas the rules follow statute in specifically designating this as a board responsibility (ARM 32.28.2206).
- ♦ The agreement assigns the Lottery with the authority to approve and supervise the Fantasy Sports Coordinator, a position that the rules appear to anticipate as an impartial arbiter of conduct of the system (ARM 32.28.2207).
- ♦ The agreement provides the Lottery with the majority of the parimutuel facility license fees, an arrangement which was not anticipated under the board's rules (ARM 32.28.2202).

The inter-agency agreement between the board and the Lottery bears very little resemblance to the licensure structure anticipated under the rules. It is unclear whether

this situation occurred because the agreement was signed prior to the adoption of the rules, or because the board never intended to implement the rules as written. Since the agreement and rules came into force in the middle part of 2008, no further efforts have been made by the board to amend either the rules or the agreement to make them consistent with each other.

CONCLUSION

Certain provisions of the inter-agency agreement between the Board of Horse Racing and the Montana State Lottery are inconsistent with administrative rules for the fantasy sports parimutuel gambling program.

Problems Exist With Board Licensing Functions for Fantasy Sports

The board's licensing procedures for providers of fantasy sports parimutuel gambling illustrates a fundamental problem with the current approach. In its dealings with the Lottery, the board behaved more like it was procuring services under contract, as opposed to granting licensure. However, because the board is statutorily a licensing authority, none of the usual contracting controls associated with the Montana Procurement Act were applied. The board's actions were a hybrid of licensing and contracting procedures, but ultimately satisfied the requirements of neither.

Application of the Montana Procurement Act to Fantasy Sports Parimutuel Gambling

Based on the approach taken by the board in its inter-agency agreement with the Lottery, there are a lot of similarities between this arrangement and contracting procedures as outlined in the Montana Procurement Act. Several of the arguments put forward by the board in justification for the agreement also actually support the position that the Procurement Act should apply. These are discussed as follows:

- ♦ The form and content of the inter-agency agreement between the Board of Horse Racing and the Montana State Lottery meets the definition of a contract as outlined in the Procurement Act (§18-4-123 (3), MCA).
- ♦ The manner in which the Lottery's involvement was solicited and the extent of the board's efforts to solicit other applicants or vendors during the process could fall within the parameters of sole source procurement as defined under the Procurement Act (§18-4-306, MCA). If, as has been argued, the Lottery was really the only vendor capable of launching the fantasy sports gambling games, the Procurement Act would have provided a means of justifying and documenting this decision properly.

- ♦ Both the terms of the inter-agency agreement and the views of various participants in the process suggest a provider of fantasy sports parimutuel gambling would need to enjoy exclusivity in offering the games, as the relatively small size of the market in Montana would not support multiple providers. Licenses are generally granted to any applicant meeting pre-determined requirements, whereas contracts generally assume exclusivity in the relationship (at least to some degree).
- ♦ Contracts offer vendors fixed terms of service generally including a number of years in which the contract runs. The Montana Procurement Act allows agencies to specify a term of service up to seven years (§18-4-313, MCA). Both the board and the Lottery cited the need for this kind of predictability in the terms and conditions of the inter-agency agreement in order to justify the Lottery's initial investment. A grant of licensure by the board would generally be for an annual period and even where this is automatically renewed there is more limited predictability for the licensee as compared with a contractual relationship.
- ♦ The structure provided by a formal procurement process helps agencies achieve other goals (outlined in §18-4-122, MCA), including the promotion of confidence in public contracting, fair and equitable treatment for all vendors, increasing efficiency in state procurement procedures, fostering effective private sector competition, and improving the overall quality and integrity of state procurement activities.

The board's dealings with the Lottery were conducted in open public forums as part of the board's normal business. In this context, there were certainly opportunities for public review of and comment on the proposed arrangement with the Lottery. However, this approach did not provide for the formal structure of competitive bid solicitation and proposal review that happens in a procurement situation. Had the board followed the structure of the Montana Procurement Act in its negotiation and agreement with the Lottery, several problems could have been avoided. These problems relate to the ability of other market entrants to participate on an equitable basis, and the benefits that ultimately accrued to the Lottery and its main game contractor.

Lack of Open Procurement Process Benefitted Lottery and Contractor

Both the Lottery and its main game contractor have been accorded significant benefits as a result of the inter-agency agreement. Although the fantasy sports gambling games have not yet generated significant revenues themselves, the Lottery has used the new games as a vehicle for extending its retail network to bars and casinos with liquor licensing. This has provided a significant new revenue stream for the Lottery and has resulted in additional sales of conventional lottery products in excess of \$1.4 million. The following table shows sales revenues for approximately 200 retailers recruited by the Lottery to offer the Montana Sports Action fantasy sports gambling games. Revenue

amounts are broken out to show totals for the fantasy sports National Football League (NFL) and National Association for Stock Car Auto Racing (NASCAR) games, and for sales of conventional lottery products (lotto and scratch-type tickets). The table also shows the resultant commissions earned by retailers.

Table 1
Fantasy Sports Retailers' Lottery Products Sales Revenue
September 2008 through August 2009

Lottery Product & Game Type		Total Sales	Retailer Commission
Montana Sports Action	NFL	\$81,135	\$7,236
	NASCAR	\$100,225	
Conventional Lottery Products	LOTTO	\$769,371	\$70,109
	SCRATCH	\$632,371	
Totals		\$1,583,532	\$77,345

Source: Compiled by the Legislative Audit Division from Montana State Lottery records.

The Lottery is, of course, a state agency and any additional sales revenue benefits the state's general fund. The Lottery's main contractor, however, is a private for-profit business and additional revenue benefits its owners or shareholders. In addition to a share of the administrative portion or takeout from fantasy sports gambling revenues, the contractor received a three-year extension to its main vendor contract with Lottery as direct consideration for developing and administering the new fantasy sports gambling games. This contract extension is estimated to be worth in excess of \$7 million. The contractor has therefore received a considerable competitive advantage as a direct result of the introduction of fantasy sports gambling, without the benefit of an open procurement process. These benefits have accrued to the contractor based on the assumption that no other private sector options were available to the board. The board was never in a position to make this assumption as the agreement with the Lottery precluded solicitation of competitive bids through an open procurement process.

Licensing Function Is Inappropriate for Fantasy Sports Parimutuel Gambling

Under HB616, fantasy sports parimutuel gambling was designed to mirror the board's other licensure functions for live and simulcast parimutuel gambling on horse racing. Under the existing licensing functions, the board grants a license to a

network provider that is generally assumed to be exclusive in nature. The licensing rules provide for a process to choose between competing providers seeking licensure for the same horse racing meets. However, the link between live horse racing meets and simulcast parimutuel gambling on horse racing does not exist with fantasy sports parimutuel gambling. Fantasy sports parimutuel gambling is based on professional sporting leagues and events that take place outside of any regulatory supervision by the board. It appears the statutory designation of fantasy sports parimutuel gambling as a licensing function of the board was inappropriate given the nature of the activity. As discussed above, the conduct of the board in licensing the Lottery as the network provider indicates that the situation is more suited to the controls and processes of a procurement of services.

Statute Should Be Revised to Provide for Contracted Services

Revising statute to provide the board with authority to contract for the provision of fantasy sports parimutuel gambling would ensure greater transparency in the process and greater confidence in the results. It would allow the board to administer the program with greater consistency and still fulfill the goals of the original legislation to provide revenue to support the live horse racing industry in the state.

RECOMMENDATION #1

We recommend legislation be enacted to provide the Board of Horse Racing authority to contract for services, rather than license provision of fantasy sports parimutuel gambling.

Chapter III – Legal Authority for Lottery’s Involvement in Fantasy Sports

Introduction

Our third audit objective was to determine whether the Board of Horse Racing (the board) and other interested parties proceeded in accordance with statutory authority and legislative intent in considering options for implementing House Bill (HB) 616. To address this objective we reviewed legislative records relating to the bill, documents and records of the board’s deliberations on HB616, and interviewed board staff involved in the process. We also interviewed members of staff from the Montana State Lottery (the Lottery), the Governor’s Office, the Department of Administration, and other agencies involved in the process.

Legal Challenges to Lottery Involvement

Challenges to the legality of involving the Lottery in fantasy sports parimutuel gambling initially focused on whether the intent of HB616 was being met through the involvement of a state agency (the Lottery) as the provider of fantasy sports gambling. However, the involvement of the Lottery also raised questions about that agency’s legal authority to offer gambling games that are different from conventional lottery-type products. The Montana State Lottery Act of 1985 established the Lottery and outlined its legal authority and scope of activities. HB616 did not refer to the Lottery or make any changes in the Lottery Act suggesting that involving this agency was anticipated in the introduction of fantasy sports parimutuel gambling.

Interpretation of Statutes Relating to Fantasy Sports Parimutuel Gambling

The involvement of the Lottery in fantasy sports parimutuel gambling is not consistent with its scope of authority as established by the Montana State Lottery Act of 1985. The Lottery’s ability to participate in sports pools is limited to those outside the scope of the explicitly prohibited Title 23, chapter 5, part 5 pools. Section 23-5-501, MCA, defines a sports pool as a “gambling activity, other than an activity governed under chapter 4 or chapter 5, part 2, of this title, in which a person wagers money for the chance to win money or other items of value based on the outcome of a sports event or series of sports events...” Since fantasy sports leagues are authorized by Title 23, chapter 5, part 8, MCA, they are included in the “gambling activity” language included in the definition of sports pools. Lottery does not have authority to participate in activities falling in the sports pools governed by Title 23, chapter 5, part 5 as prohibited by §23-7-102(3)(b), MCA.

The issue of legislative intent relative to HB616 is more difficult to address as application of legislative intent is frustrated where there is no underlying statutory guidance. This supports the view of the board and other participants in the process, who believe that the intent of HB616 was to provide revenue for the Board of Horse Racing to support the horse racing industry, rather than to specifically define how the new fantasy sports gambling program was to be administered.

However, neither interpretations of legislative intent nor the narrow definitions-based nature of the legal analysis changes the underlying issue; by offering fantasy sports parimutuel gambling games (whether this done on behalf of the board or not), the Lottery is acting outside of its statutory authority and the activities are not in compliance with the law.

CONCLUSION

The Board of Horse Racing and the Montana State Lottery did not proceed in accordance with statute in implementing HB616. Although HB616 does not identify a specific means of implementing fantasy sports parimutuel gambling, the involvement of the Montana State Lottery is not in compliance with statute.

Involving the Lottery Was Expedient, But does not Comply with Statute

Staff and appointed officials from the board, the Lottery and the Governor's Office have stated that involving the Lottery as a provider of fantasy sports parimutuel gambling conformed with the intent of HB616 and offered an expedient and effective means of implementing the legislation. There is evidence to support the assertion that the Lottery was in a position to implement the new fantasy sports gambling program quickly (the Lottery was able to establish the program in around three months). By the middle of 2008, the board viewed the launch of fantasy sports gambling in time for the upcoming National Football League season as imperative to its continuing survival. It appears that expediency outweighed any concerns with the legality of involving the Lottery.

Although the board and the Lottery obtained legal analysis through the Department of Administration, they did not seek a resolution of the issues through a formal approach to the Attorney General's office or through legislation during the 2009 legislative session. Either course would have offered an opportunity to clarify legal interpretations regarding the Lottery's scope of authority and provided a more stable basis for offering fantasy sports parimutuel gambling over the long term. In the absence of these efforts,

we have little choice in how to approach noncompliance with state law. Activities that are outside of an agency's legal authority and are not in compliance with statute should cease.

RECOMMENDATION #2

We recommend the Board of Horse Racing and the Montana State Lottery operate within their statutory authority and terminate their inter-agency agreement on fantasy sports parimutuel gambling with immediate effect.

BOARD OF HORSE
RACING

MONTANA STATE
LOTTERY

AGENCY RESPONSES



MONTANA DEPARTMENT OF LIVESTOCK

A-3

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September 18, 2009

The Legislative Audit Committee
of the Montana State Legislature

RECEIVED

SEP 18 2009

LEGISLATIVE AUDIT DIV.

Members of the Committee:

I am writing on behalf of the Board of Horseracing (Board) in response to the September 2009 Performance Audit report on Fantasy Sports Parimutuel Gambling.

The Board does not concur with the audit report's first conclusion that the legal basis for Board of Horse Racing rules on fantasy sports parimutuel gambling is unclear. The legislature provided a clear legal basis for the Board to adopt rules on fantasy sports in §23-4-104, MCA which states "[t]he board shall adopt rules to govern race meets and the parimutuel system. These rules shall include the following:

...
(12) the time, conduct, and supervision of simulcast races and fantasy sports leagues and parimutuel betting on simulcast races and fantasy sports leagues." The time, conduct, and supervision of fantasy sports leagues and parimutuel betting on fantasy sports leagues necessarily includes all aspects of the fantasy sports parimutuel gambling.

The Board concurs in part with the audit report's second conclusion in that the rules contemplate a network and hub license while the Interagency Agreement covers exclusivity over an eight-year term. Accordingly, the Board will propose rule changes to provide that the parimutuel network, parimutuel network director, and the parimutuel hub will contract with the Board given the necessary investment required to provide these services and the relatively small size of the market as recognized in the audit report. The Board will continue licensing parimutuel facilities on a year to year basis.

The Board disagrees with Recommendation #1 that legislation needs to be enacted to provide the Board authority to contract for services. The Board is recognized as a Department Head pursuant to § 2-15-102(5), MCA. Department heads, pursuant to § 2-15-112(2)(d), MCA, have the power to "enter into agreements with federal, state, and local agencies necessary to carry out the department's functions." The Board's action in contracting for services is consistent with board actions in other departments. No further legislation is necessary. As stated above, the Board will meet the intent of the audit report's recommendation by making the appropriate amendments to the rules on Fantasy Sports.

Recognizing that the Board entered into a contract for services with Montana Lottery, the Board seeks to clarify to the Committee that it did, in fact, follow Montana's Procurement Act. Pursuant to § 18-4-132(3)(a), MCA, the procurement procedures for contracts for services do not apply to "either grants or

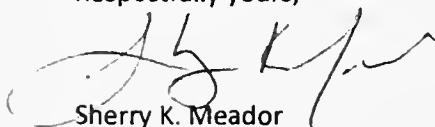
contracts between the state and its political subdivisions or other governments . . .” Accordingly, the Board was not required to engage in the extended process to provide services given that those services could be effectively provided by another state agency. Montana Lottery’s implementation of the game was a valuable use of existing governmental resources for the public good.

The Board does not concur with the audit report’s conclusion that Montana State Lottery is not in compliance with statute. The Lottery’s ability to participate in sports pools is limited to those outside the scope of the explicitly prohibited Title 23, chapter 5, part 5 pools. However, fantasy sports are not included in the definition of sports pools under Title 23, chapter 5, part 5, but are authorized in statute under Title 23, chapter 5, part 8. Sports pools are defined in §23-5-501(1), MCA as “a gambling activity . . . in which a person wagers money for each chance to win money or other items of value based on the outcome of a sports event or series of sports events . . .” In a written statement to the National Collegiate Athletic Association, Attorney General Steve Bullock clearly distinguished fantasy sports from the definition of sports pools in saying “[f]antasy leagues have nothing to do with the outcome of any sporting events. These leagues are based on the combined performance of individual players, irrespective of their team affiliation. Mont. Code Ann. §23-5-801. Moreover, points are assigned on the basis of performance of the individuals, not the teams. Indeed, league winners have nothing to do with which team wins or loses games. The statutes make it clear that they “do not . . . authorize betting or wagering on the outcome of an individual sports event.” Mont. Code Ann. §23-5-806(1).” He further states that “Montana’s parimutuel fantasy sports on-line lottery game, as described in Mont. Code Ann. §§23-4—301(8) and 23-5-801 to -810, is indistinguishable from the fantasy games conducted in person.”

Attorney General Bullock’s interpretation of fantasy sports is consistent with the Board’s legal analysis prior to entering into the Interagency Agreement with Montana Lottery. The Board would be open to the Committee’s request for an additional statement of the Attorney General if a more formal opinion is deemed necessary.

The Board disagrees with Recommendation #2. As stated above, the Board of Horse Racing and the Montana State Lottery have operated within their statutory authority and will continue to provide the fantasy sports games as agreed. The fantasy sports game is well regulated, well received, and has provided the necessary funding to meet its purpose which is to help horseracing. The Board believes it is in the best interest of the public and of horse racing to continue its relationship with Montana Lottery in operating Fantasy Sports.

Respectfully yours,



Sherry K. Meador

Contracted Legal Counsel

Montana Board of Horse Racing



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September 16, 2009

The Legislative Audit Committee
of the Montana State Legislature

RECEIVED
SEP 18 2009
LEGISLATIVE AUDIT DIV.

Members of the Committee:

I am writing in response to the Draft Performance Audit Report on Fantasy Sports Parimutuel Gambling of September 2009.

I appreciate the detailed attention the Legislative Auditors have given this program, but respectfully do not concur with conclusion 2 and recommendation 2 of the Performance Audit, specifically regarding the legal authority of the Lottery's involvement in Fantasy Sports.

The Lottery engaged in significant due diligence before agreeing to assist the Board of Horseracing in this endeavor. We discussed the prospect with the Department of Justice and sought a legal opinion of our legal counsel, Mike Manion of the Department of Administration. It is the opinion of both the Lottery and our legal counsel that the Lottery does in fact have the legal authority to conduct Fantasy Sports wagering on behalf of the Board of Horse Racing and so an inter-agency agreement was developed.

Fantasy Sports wagering conducted by a partnership between the Board and the Lottery is authorized by Montana Code Annotated § 23-5-8. Your analysis appears to have perhaps confused "sports pools" as authorized in Title 5, Chapter 5, Part 5, with Fantasy Sports which are authorized and conducted by the Board and the Lottery in Title 23, Chapter 5, Part 8.

In fact, in a letter to the National Collegiate Athletic Association (NCAA), Attorney General Steve Bullock clearly differentiates sports pools found in § 23-5-501 from Fantasy Sports found in § 23-5-801. Attorney General Bullock opinion states that "Montana's Parimutuel Fantasy Sports on-line lottery game, as described in Mont. Code Ann. 23-4-301(8) and 23-5-801 - 810, is indistinguishable from the Fantasy Sports games conducted in person." The NCAA and its legal staff found Attorney General Bullock's opinion persuasive and concluded that Montana's Fantasy Sports games did not abridge either federal law or NCAA regulations or policies.

The Performance Audit Report also indicates a need to utilize the Montana Procurement Act. However, the Board and the Lottery were not required to follow the Montana Procurement Act in the implementation of Fantasy Sports Parimutuel Gambling as the agreement would be between two government agencies and no private party was involved. Given the dire economic circumstances that the Board of Horse Racing found itself in during the spring of 2008, it is understandable that the Board looked to use the existing resources of the State of Montana to meet the mandate of HB 616, which was to provide a funding source to help save the sport of horse racing in Montana.

In the spring of 2008, the Department of Livestock's Board of Horse Racing was struggling to implement a Fantasy Sports program as envisioned by HB 616. Faced with an extremely complicated subject and severe budgetary shortfalls, the Board of Horse Racing met with the Lottery to see if existing state resources could be utilized to implement HB 616. An open public meeting was held in the spring of 2008 by the Board of Horse Racing to review a proposal for an inter-agency agreement between the Lottery and the Board to develop market and produce a Fantasy Football game in time for the 2008 professional football season. The Board indicated at that meeting that if the Board did not receive an immediate and steady influx of income, there would be no horse racing in Montana the next spring.

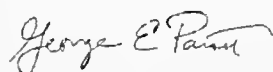
As the Board of Horse Racing lacked the financial and staffing resources to implement HB 616, the Board of Horse Racing and the Montana Lottery Commission both agreed that a joint venture was best available option. The Lottery also entered into an inter-agency agreement with the Montana Department of Justice to share background investigations for licensing of Fantasy Sports Retailers. A similar agreement has existed between the Department of Revenue and the Department of Justice for years.

This joint government agency venture resulted in a Fantasy Sports Football game being developed, implemented and marketed within less than four months. Using the existing contract the Lottery had with its vendor, the Lottery was able to develop a Fantasy Sports game, deploy hardware and software into over 100 retail locations and begin selling the game in time for the football season kickoff.

The benefits to both the Board of Horse Racing and retailers are clear. The Board has seen an immediate influx of operating revenue which allowed it to continue operation, and retailers have benefited by increased traffic in their locations and additional revenue. Abrupt termination of the existing program could end Montana's racing program by removing this revenue source without replacement and retailers would lose on investments already made.

The Lottery and the Board of Horse Racing believe that we are on the right track with Fantasy Sports Parimutuel wagering. There may be a difference of legal opinions on statutory authority and where it should reside, and the Lottery and the Board stand receptive to recommendations of the members of the Legislative Audit Committee to improve this program.

Sincerely,



George E. Parisot, Director
Montana Lottery

